Scenarios for economic and political development in the medium and long-run

Vasyl Yurchyshyn,
Razumkov Centre, Kyiv, Ukraine

Prepared for the International Expert Seminar
Ukraine, the European Union and International Community: Current Challenges and the Agenda for Overcoming the Stalemate
WIIW, Vienna, Austria – 21 June 2010

A brief analysis of the key economic challenges facing Ukraine and the main prospects for acceleration of the economic dynamics and improving the business environment are presented in this paper. The disproportionally huge impact of the world economic and financial crisis on Ukraine, compared to other economies, requires a careful assessment of the pre-crisis economic situation. A good understanding of these issues is necessary to evaluate current macroeconomic conditions and midterm policies, in order to achieve sustainable economic recovery and growth.

The shocking economic decline in Ukraine was mainly caused by the strong politicisation of economic decisions, rendering impossible the approval of a coordinated anti-crisis programme by the relevant authorities. The characteristics of today's Ukraine are large budget deficits, inflation, a high foreign debt, distrusted banking system and loss of confidence in public policy.

Some characteristics of the Ukrainian economy in the crisis period and its current situation are presented in chapters 1 and 2. In chapter 3, we discuss the importance of the collaboration of Ukraine with the IMF, which we envisage as the basis for economic recovery. We subsequently present two potential scenarios – optimistic and realistic ones – for the economic development of Ukraine in chapter 4, analysing advantages and risks of each. Some conclusions on scenario realization are provided in the chapter 5. Two appendices would be reasonable to clear up aspects of assessments of Ukraine's economy by households.

1. Losses of Ukraine's economy in the crisis period

From the beginning of the millennium until the autumn of 2008, Ukraine exercised rather positive economic dynamics, in which the average growth reached 7.5%. After this, the global economic and financial crisis caused a huge negative pressure on Ukraine. How may the losses of the recession be measured? Several observations would be reasonable.

(1). In 2009 **GDP per capita dropped** to only $ 2500 (in current USD), reflecting 110th place in the world according to the IMF assessments (Table "*GDP per capita in Ukraine*").

GDP per capita in Ukraine

2001		*2005*		*2007*		*2009 (e)*	
$	*$ PPP*	*$*	*$ PPP*	*$*	*$ PPP*	*$*	*$ PPP*
766	4350	1761	6848	3035	6914	*2500*	*6400*

Source: IMF

(2**). Decline in wages** and income of population (Table "*Average wages in Ukraine*") – 27% in $-term[1].

Average wages in Ukraine
(end of the period)

	2007	*2008*	*2009*
Monthly average wage, UAH	1475	1917	1950
… in $	292	333	244

Source: State Committee of Statistics of Ukraine. Estimation: author.

(3). The **decline in real GDP** in 2009 **– by 15.1%** (industrial production – by 22.0%, construction – by 45.9%, transport – by 48.0%; drop in fixed investments – by 46.2%), was led mainly by exports collapse, crunches in credits and domestic savings together with a shortage of own resources of the corporate sector. These negative results destroyed sources and stimulus for the infrastructure transformation and modernization.

At the same time, the **risky performance of Ukrainian economy** was proven by the following additional **components**:

- *Internal*
  - The consumer-oriented domestic demand with low income, for 2009 particularly:
    - Final consumer consumption – 84.6% of GDP (with private consumption of 65.4% and public consumption of 19.2%),
    - investments – 17.1% of GDP[2].
  - The main goods of the Ukrainian economy are those with low processing degree or semi-finished goods, which are largely dependent on energy (imports). As a consequence, vast consumption of imported materials and energy resources, whose cost will only grow in the long run, points to the low effectiveness and efficiency of the national economy.
- *External*
  - Rather high openness of the economy: in 2009 exports amounted to 46.3% and imports to 48.0% of GDP;
  - The lack of diversification of this open economy, in which over 50% of total exports are comprised by only a few products of low added value, such as metals, grains and agrarian products.
  - The exports of the country have a narrow geographic diversification. The key trading partners of Ukraine, i.e. Russia, Turkey, Italy, Poland, Belarus, and Germany, take a half of total exports;.
  - The high volatility of demand for Ukrainian exports. Since global demand for exports, especially for low value-added goods, tends to fluctuate significantly due to business cycles, export revenues for Ukraine remain unstable and unpredictable.

(4). Deterioration of public finances in 2008-2009, with high general government deficit (in 2009 around UAH 70 bn or 7.5% GDP)[3]. For reasons of stability, Ukraine's central bank – National bank of Ukraine (NBU) – attempted to restrict money supply but, due to poor policy coordination, the fiscal policy remained loose in 2009. Thus, **NBU monetized fiscal deficit** by repurchasing T-bills

---

[1] National currency – hryvnia (UAH). Average exchange rate: 2007 – 5.05, 2008 – 5.8, 2009 – 8.0 UAH/$1.
[2] Compare with investment's share 22-26% of GDP in previous 5 years.
[3] The consolidated budget deficit was reported at about 4% of GDP in 2009. However, if includes the public funds used to recapitalize commercial banks and the state-run natural gas company Naftogaz (about 5% of GDP) and the extra expenditures to cover the Pension Fund deficit, the overall fiscal deficit in 2009 totaled about 11.5% of GDP. Well, Ukraine is not unique in terms of fiscal deficit increased during crisis.

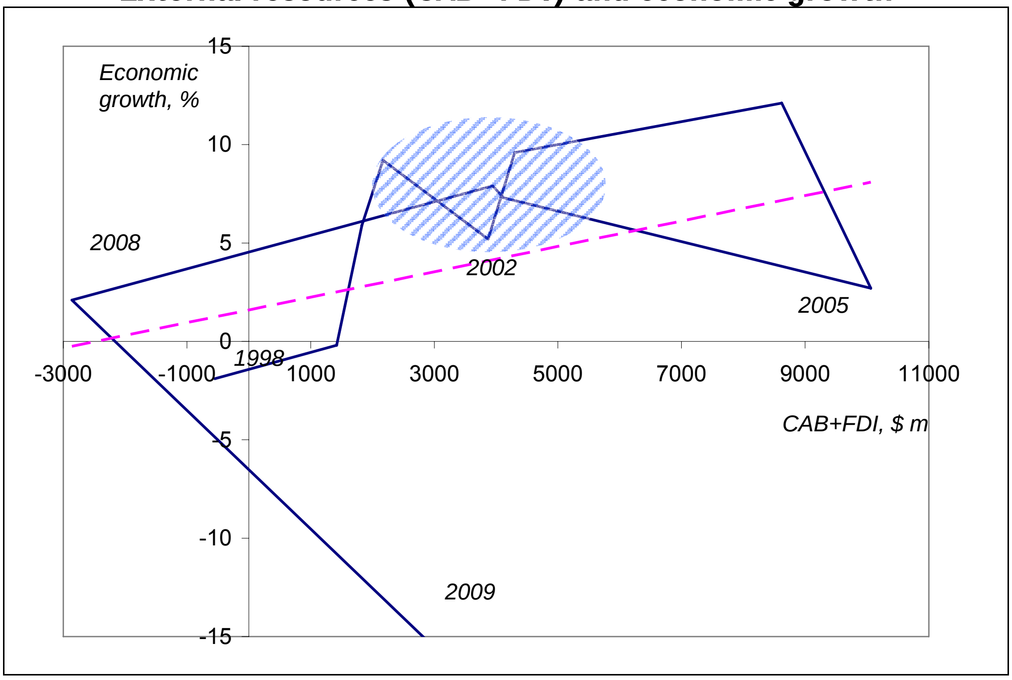
(amounted 8.4% of GDP), in parallel with sterilization of $4 bn liquidity (6% of M3) of the banking sector.

(5). The resultant crowding out effect (fall of domestic credit to private sector) increased liquidity risks and growth of non-performance loans' (NPL) share in bank portfolio to 34% (Fitch). Moreover, with more than **half of all outstanding loans in the Ukrainian banking system denominated in foreign currencies**, both borrowers and commercial banks were exposed to currency risks, which led to losses of public confidence in the banking system.

(6). In 2009 merchandise **imports declined by 44.0%; exports by 37.0%**, in comparison to 2008. As a result, the Current Account deficit reduced to 1.9% of GDP in 2009 (CAB deficit 7% of GDP or $13 bn in 2008).

(7). The huge current account deficit in 2008 and decline in FDI in 2009 due to the escalating economic crisis in Ukraine were among serious factors of economic decline in H2'2008-2009. **Narrow and uncompetitive exports and a worsening investment climate** significantly reduced external resources for economic growth[4] (Diagram "*External resources and economic growth*").

External resources (CAB+FDI) and economic growth



Source: State Committee of Statistics of Ukraine (Derzhcomstst). Estimation: author.

(8). The total **external debt increased to $104bn** (as for the beginning 2010) – around 85% of GDP, with significant growth of the sovereign debt rising by 49% (to $18bn) during 2009 (table "*Ukraine's external debt*"). At the same time, the banking system visually improved debt position. Over the past several years, Ukraine borrowed excessively from abroad to finance sharply increased domestic consumption and investments. The international liquidity crisis led to a reversal

[4] Disbursements IMF stand-by tranches of $6.1bn, financial support of other IFIs (such as WB, EBRD, etc.) helped to cover Ukraine's external financing gap in 2009.

of capital flows, which drained liquidity in the banking sector, depressed credit, investment and consumption. All of this exerted a heavy toll on the economic activities of the country[5].

Ukraine's external debt

$ bn (as for the beginning of the year)

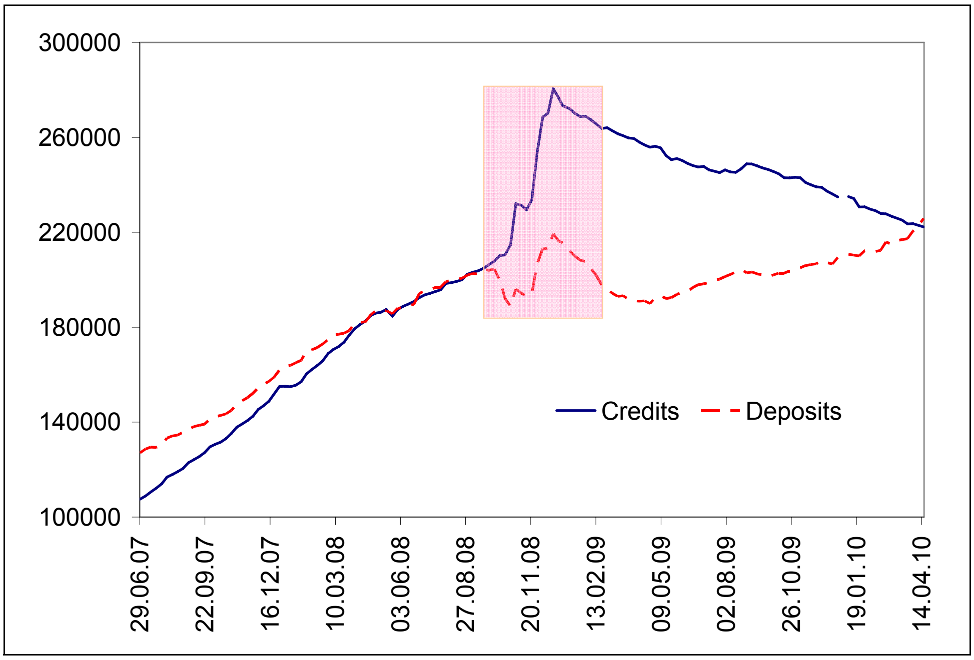
	2008	*2009*	*2010*
Government	11.9	12.0	17.8
NBU (Central Bank)	0.5	4.7	6.2
Banking system	30.9	39.5	30.8
Corporate	33.6	41.3	44.1
Total	**80.0**	**101.7**	**104.0**

Source: NBU.

(9). Underdeveloped and unstable banking sector – though loans-to-GDP ratio (total loans to non-financial customers) increased – at the end of 2008 amounted 48.5% (UAH 460/950), in 2009 – 52.7% (UAH 482/915), but mainly due to GDP decline. Decline is observed for the credits to households – in 2008 – 54.9%, 2009 – 48.8% of total credit portfolios. This produced **real shocks for business and households** after several years of rapid growth of crediting (Diagram «*Credits and deposits of households*»)[6].

Credits and deposits of households,

UAH ml



Source: NBU.

It must be admitted that in the coming 2-3 years, the hopes for at least partial restoration of noticeable positive dynamic of growth of individual deposits in the banking system are very weak,

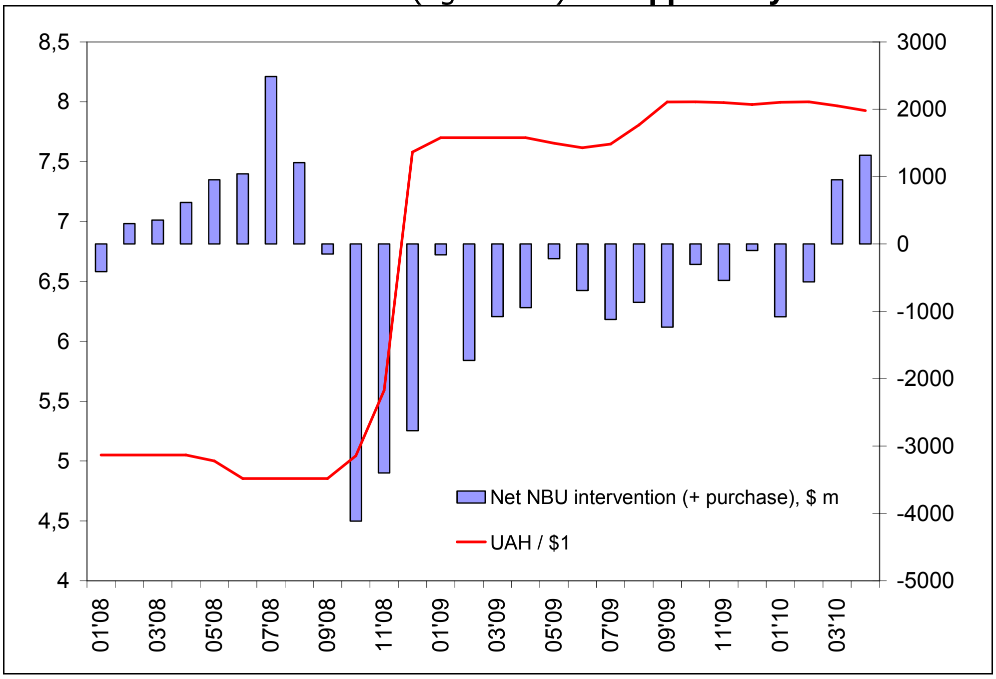
[5] See also: The Impact of the Global Liquidity Crisis on Ukraine and the Road to Economic Recovery. The Bleyzer Foundation Position Paper. – FORUM ON THE ECONOMIC DEVELOPMENT OF UKRAINE. Washington, D.C., Oct. 2009.

[6] In 2005 – H1'2008, Ukrainians got access to new (for them) sources of enhancement of their wellbeing. Over these years, the banking sector had been experiencing an extraordinary, unsustainable expansion, as bank lending grew by over 70% per year. Relative macroeconomic stability (not seen by the country before the beginning of 2000s), entrance of many foreign owned banks, inflow of foreign currency facilitating support for the national currency and involvement of domestic banks in international financial flows, promoted: *first*, substantial growth of individual deposits (that, in turn, provided resources for the banking system), *second* – access of the national banking system to cheap resources of international banking structures (which also enabled build-up of the internal borrowing base).

due to serious miscalculations of the country's central bank during the crisis developments in the autumn of 2008, and the persisting strong mistrust in the NBU policy[7].

(10). Over many years (actually, since 2001) Ukraine **exercised an exchange rate** of UAH which was **actually fixed**. During the period inflation remains high. Sooner or later, this loss of competitiveness should have been restored through corresponding exchange rate adjustments. Crisis in the autumn of 2008 caused a crash for UAH purchasing power and NBU was obliged to spend huge amount of reserves to prevent further losses (Diagram "*Central Bank intervention to support hryvnia*").

NBU intervention (right scale) **to support hryvnia**



Source: NBU.

2. Ukraine: back on recovery in early 2010 and further growth?

Following a sharp decline in GDP in 2009, Ukraine now demonstrates some steps toward recovery. There is supportive external demand that has a positive impact on exporting sectors and helps to sustain economic recovery. The chances that former sources of economic growth (domestic consumption resting on wider access to credit resources, and exports resting on a favourable pricing situation) will further ensure GDP growth are, however, very low.

The important factor for recent development and an optimistic outlook for the coming months is the **consolidation of political power with the leadership of the President**, which should help Ukraine's economic environment to be more predictable and transparent, make national business and international investors more optimistic about Ukraine's prospects.

Political consolidation. After the presidential elections quick consolidation of power by the winner was fulfilled:

- A new Parliament coalition lead by the party of the President – Party of Regions (PR) – was formed,

[7] Unfortunately, authorities failed to control the use of the liquidity support that was provided initially to a number of banks in crisis period. It appears that these funds were used not to revive domestic lending as initially expected, but that were used to buy foreign exchange to transfer it abroad. That contributed to UAH high depreciation pressures. See, e.g.: Specificity of the Swedish monetary policy. – *National Security & Defence*, 2009, No.1, p.51-56.

- A new government was formed primarily from the representatives of PR, that means consolidation of the executive branch of power also,
- Rotation on the regional level provided the possibility for the government and President to hold new consolidated policy on the regional level,
- Permanent (for last 5 years) conflicts (with blockings and tensions) between President and the government were dismissed,
- The President and the government received a possibility to realize their initiatives under the support of the "friendly" coalition.

Political consolidation should provide businesses and investors with more certainty concerning Ukraine's future prospects. However, the endurance test of the governmental power is to be fulfilled in late October 2010, at elections for local Ukrainian authorities. Clearly, before that period the Government will avoid harsh stabilization steps, by conducting financial and commodity interventions to balance the domestic demand. The maintenance of economic control in the interim would result in an increase in the influence of political power.

Economic improvement. At the same time, the low **comparative base of the previous year** (industrial output declined by 31.8% in Q1'2009) also gives a ground for very positive results of output growth. Industrial output grew by 12.6% in January-April 2010, including double-digit growth in the main industries: metallurgy (+22.2% yoy), oil-chemical industry (+23.8%) and machinery building (+28.0%).

In April-May, a further reduction of inflationary pressure is observed, with 0.3% and 0.6% deflation in those two months. BoP continued to improve; both current accounts and capital accounts demonstrate surpluses. Surplus of CAB is estimated at $109 m, international reserves grew by $600 m. National currency hryvnia is appreciated slightly (see Diagram "*Central Bank intervention to support hryvnia*" above).

Public finances remained under significant strain during the first months of 2010. Despite a stronger recovery, budget revenues performance was rather weak. The consolidated budget deficit amounted to 2% of GDP in Q1'2010. However, the official deficit did not include Pension Fund and Naftogaz imbalances as well as bank recapitalization spending; hence, the broad fiscal deficit was estimated at about 7-8% of GDP. The deficit was primarily financed by new domestic borrowing. The lion's share of government T-bills was purchased by the NBU, implying indirect monetization of the budget deficit[8].

Can we hope for recovery in short-run? Some doubts in terms of GDP structure:

- ***Final consumption*** expenditure of households in the near future will not grow appropriately. Despite GDP growth retail trade turnover continued to decline (January-April'2010 – 97% yoy), indicating a further cooling of domestic demand and household consumption;
- ***Investments*** – current economic policy does not create incentives and preconditions for increasing capital investment, neither from the state budget nor local budgets, nor from enterprises' own funds;
- ***Net exports*** remain volatile and dependant on the pace of recovery in the world economy, in particular the demand for key Ukrainian exports.

Note, in the conditions of decreasing world demand for Ukrainian exports, the main trade and investment flows have been reoriented to Russia and CIS. Since the dynamics of the **Ukrainian economy seriously depend on the dynamics of the economy of Russia**, the problems experienced by the latter may complicate Ukraine's prospects of economic recovery in the short or even middle run.

[8] For more details see: O.Pogarska, E.Segura. Ukraine. Macroeconomic Situation. – SigmaBleyzer, April 2010.

Meanwhile, in the short-run (in 2010) it is reasonable to expect:

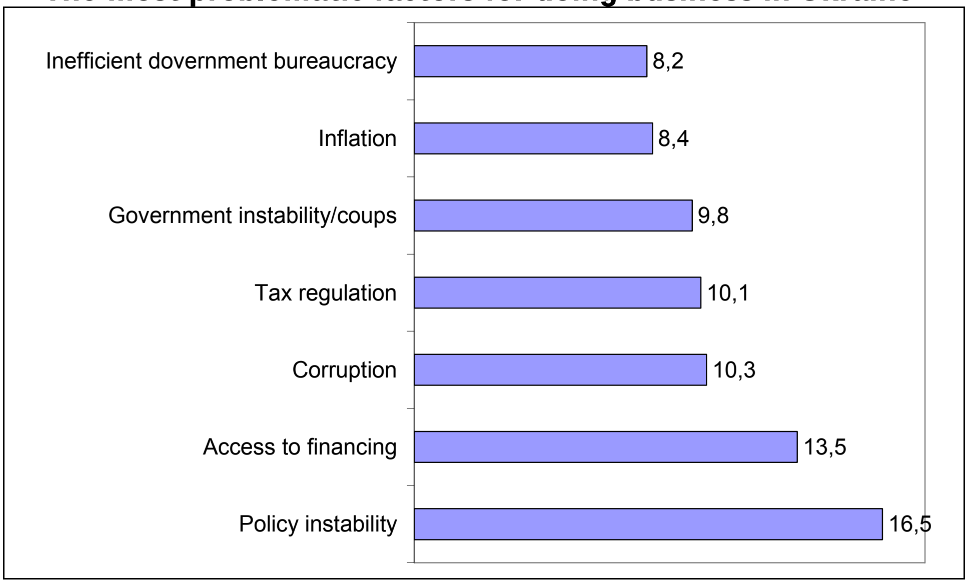
- further improvement of the current account balance, reflecting price reduction for imported gas,
- lower inflation (less than 10% yoy) in the event of a postponed rise in gas tariffs for households and industries,
- discount for imported gas supports price competitiveness of basic exporting industries that expands resources for macroeconomic stabilization,
- further price stabilization due to hryvnia appreciation (declining pressure from the current account).

At the same time it should be mentioned that state measures to support the economy inevitably mean substantial growth of the government role in business. This may **result in politicisation, deinstitulisation** (institutes' destruction) **and monopolisation of the economy** and curtailment of private initiatives.

Institutional Outlook. Recently Ukraine continued to loose in competitiveness, first of all due to weak institutions, public management and politicisation of economic decisions, etc. which is confirmed by the International Ratings. In particular, general observations from *Doing Business 2010* summarize the following aspects (see Diagram "*The most problematic factors for doing business in Ukraine*")[9]:

- The quality of the business environment in Ukraine remains unsatisfactory – the country is ranked 145th out of 183 countries in terms of *Ease of Doing Business*;
- Domestic and foreign businesses still face an onerous burden of excessive and costly regulatory, licensing and taxation procedures;
- Weak investment climate continues to hold back the development of the Ukrainian private sector, which restrains the growth of investments, employment, output and welfare.

The most problematic factors for doing business in Ukraine



Source: Doing Business 2010

As for economic growth, **past sources** (that is, major increases in domestic consumption and exports), as mentioned earlier, **are unlikely to be the main drivers for Ukraine's GDP**

[9] Source: Doing Business 2010. – *http://www.doingbusiness.org/. Doing Business* is produced by the World Bank Group and presents quantitative indicators on business regulations and the protection of property rights that can be compared across 183 economies.

growth in the future[10]. Therefore, in order to accelerate economic development, authorities will need to find new ways to increase domestic and foreign direct investments, which will encourage output and productivity growth. This means that the **authorities will need to demonstrate that Ukraine's investment climate is changing rapidly for the better**.

3. Collaboration of Ukraine with the IMF as the basis for economic recovery

The discussed trends for a certain improvement of the political and macroeconomic situation in Ukraine caused the spread of a general belief in political circles that Ukraine has already reached a steady state of growth. Nevertheless, as it was during the previous years, **these trends are neither stable nor irreversible**. Risks' trends may contain both external factors (e.g. possible dissemination of the "second wave" of the European economic and financial crisis followed by its negative impact on Ukrainian exports and capital inflows into Ukraine) and internal processes (e.g. deterioration of the financial stability of the banking system and increasing fiscal problems as the result of the suspension of economic recovery).

To stimulate economic development, a new Government program was prepared and presented for public, businesses and investors at the beginning of June 2010 (see "*Main priorities of new program for economic reforms*"[11]).

The program is very ambitious and too optimistic, taking into account available resources and current governmental practices. Moreover, the experience of previous attempts at reforms has shown that the **Ukrainian government has no particular experiences and incentives for the independent introduction of systemic transformations**. Actually these factors might lead to two basic scenarios for the development of Ukraine in mid- and long-run (see below). The successful implementation of the Program means fruitful cooperation with IMF and other IFIs, as well as rapid economic growth and social development. Postponement or delay of the reforms will push Ukraine into slow and poor economic activities, at least in mid-term.

Main priorities of new program for economic reforms

The Committee for Economic Reforms has been established under the President to create and deliver an economic reform program for 2010-2014. Among the main priorities of the programme are: (i) setting a framework for ensuring long term macroeconomic stability; (ii) keeping low inflation; (iii) stabilizing public finances and (iv) developing a more sustainable financial sector. In pursuit of these, major directions of the reform plan are as follows:

- Introducing mid-term budget planning and fiscal rules, in order to stabilize the budget throughout the economic cycle;
- Balancing the Pension Fund: the measures aimed to enhance systematic solidarity in the pension granting and indexation mechanism, as well as introducing mandatory state pension insurance by 2014;
- As for the monetary policy, its main goal will be to bring core CPI inflation to single digits from 2010;
- Consolidating the banking sector and improving the banking supervision, in order to make the financial sector more sustainable in future.

The Government is concentrating its attempts on reducing the budget deficit and expanding

[10] See also: The Impact of the Global Liquidity Crisis on Ukraine and the Road to Economic Recovery. The Bleyzer Foundation Position Paper. – FORUM ON THE ECONOMIC DEVELOPMENT OF UKRAINE. Washington, D.C., Oct. 2009. In Ukraine problems in many aspects are also associated with politicization of economic environment, ineffective governance, administration etc. See also: Ukraine: International Experience in Resolving Financial Crises. – The Bleyzer Foundation, 2008.

[11] Source: Committee for economic reforms. – *http://www.kmu.gov.ua/control/uk/publish/article?art_id=243337174&cat_id=243337165.*

revenue sources (via such means as introducing taxes on luxury products, and hiking excise rates and royalties for natural resources extraction). Aiming to bring public finances back to a sustainable position without choking off the nascent economic recovery, the Government announced that an overall deficit would not exceed 6% of GDP (including the state monopoly *Naftogaz*) and it would be necessary to achieve these objectives. A significant reduction is expected for quasi-fiscal deficit of *Naftogas:* from $4.2bn in 2009 to $0.3bn in 2010. The necessary measures include also a 100% increase of gas tariffs for regional district heating companies and population.

It is, however, obvious that, for returning to the path of sustainable economic growth, it is not enough only to solve the problems caused by the global economic crisis. It is clear that overcoming the effects of the fall in the mid- and long-term can be achieved only by having dealt with a number of internal and external negative factors[12]:

- Reduction of the working age population,
- Outdated production capacities;
- Increased international competition and protectionism, which intensification can be explained by losses caused by the crisis and the need to protect domestic markets and producers.

At the same time, it is necessary to identify and recognize the risks concerning the **deinstitulisation of the economy.** Governmental measures designed to support certain sectors of the economy will inevitably lead to the significant growth of the state's role in economic life (including growth of the share of enterprises and banks with a state interests). This may result in growing politisation and monopolisation of markets, reduced effectiveness of resource use and restriction of private initiative, etc.

The required reforms must bring meaningful and long-lasting transformations and should include[13]:

- Fundamental transformations ensuring the stability and predictability of the legislature and the judiciary,
- A set of measures aiming to deregulate and liberalise business activities through the radical reduction of red tape, as well as streamlining and simplification of the regulatory environment,
- Complex measures to promote and diversify exports. This axis is particularly important, since the traditional sources of export growth (metals and chemical products) are unlikely to maintain their growth at such high rates, as was characteristic in the past,
- A broad revision of the national energy policy, which should improve energy infrastructure, increase efficiency of energy consumption, diversify energy supply (including incentives for broad adoption of alternative energy sources) and strengthen competition in the energy sector;
- Measures aiming to encourage entrepreneurship and development of small businesses, by supporting a competitive and growing private sector, reducing the costs of doing business, de-regulating and strengthening corporate governance;
- Entry into free trade agreements with other countries. The proposed Enhanced Free Trade Agreement with the European Union would bring Ukraine into the supply chain of Europe and promote exports.

Under these conditions, a crucially important role will be played by the Program of cooperation between Ukraine and the IMF, which is designed to support the process of economic recovery in Ukraine which, although started, is yet extremely fragile. Restoring cooperation with the IMF

---

[12] See: Recovery of the economic growth of Ukraine. – K.: 2009. (Russian).
[13] See also: The Ukraine Competitiveness Report 2008. – *http://www.weforum.org/pdf/Global_Competitiveness_Reports/Reports/Ukraine.pdf.*

means also improving collaboration with the World Bank and EU, which gives investors a positive signal on the reduction of macroeconomic risks. And *vice versa* – the failure in adoption of the Program for cooperation between Ukraine and the IMF means increasing economic imbalances, capital outflow, and social losses[14]. This becomes particularly important due to a new wave of the financial turmoil in Euro-zone that might impose some additional constraints for financing to Ukraine.

At the same time there exists a significant internal risk for further Ukraine-IMF co-operation: relevant **agreement can be postponed until after the local elections** in the autumn 2010. Despite this risk we consider **the agreement with the IMF to be reached within the next months**.

4. Scenarios for economic development of Ukraine

In the meantime, **current slight progress** in economic recovery and financial improvement creates a **false impression on the possibility of further delays with profound economic reforms** aimed at overcoming the chronic imbalances of the financial system. "Relaxation" of urgency of the current need for funds may push the IMF to postpone actions to be taken to open a credit application, which might be seen as unpopular in Ukraine[15]. As a result, the **reforms can be generally postponed for indefinite terms**. This very quickly will lead to frustrating business and investors and, consequently, to new socio-economic losses.

It is important to distinguish the risks and caveats associated with the non-renewal of a continued cooperation and of sustainable crediting Ukraine, according to the old IMF program Stand-by, or with the absence of a new program of cooperation with the IMF[16]:

- Failures in full balancing public finances;
- Automatic blocking or high cost of alternative external financing (including adopted €500m from EU);
- Impossibility to reduce tax rates; to optimize the tax burden, which (taxes) are required by the economy for its acceleration;
- Increasing role of issues related to exporting VAT refund, increasing both business debts to the budget and budget debts to business;
- Continuation of the policy of active domestic debts. This will lead to growing of the pyramid of domestic T-bills as an alternative to crediting the economy with bank credits;

[14] Experts expressed high confidence that in late May 2010 the IMF mission would take a positive decision on the Programme Ukraine-IMF and would provide a loan tranche of $3-5bn. However, until mid-June (when this publication was prepared), Ukraine has not demonstrated a real willingness to fiscal consolidation and transparency, in contrast to most European countries that have expanded measures to strengthen fiscal and financial stability. In such circumstances, the visit of the IMF mission to Ukraine, as well as the prospects of restoring full cooperation Ukraine-IMF, has been postponed.

[15] At 9 June President of Ukraine had talks with the IMF-representatives in Kyiv. During the meetings, discussions were focused on fiscal policies to achieve the 2010 fiscal target, public debt declining and structural reforms, in particular on financial and energy sectors to place Ukraine on a path towards stability and growth. The meetings will restart on 21 June when a full IMF mission will come to Kyiv.

[16] Ukraine's budget for 2010 has a $4.3bn allowance for FX borrowing, including $2bn from the IMF. As the IMF appears reluctant to lend to the government for budget financing purposes, the government now is able to substitute IMF budget funding with the Russian loans. Note that for other IFI financing to materialize ($1.1bn), a **resumption of co-operation with the IMF is still seen as a prerequisite**. In absence of such co-operation program, the country would have adequate alternative financing sources, such as domestic market and bilateral loans, including from Russia. (At the beginning of June Ukraine really borrowed $2bn from Russia to bridge the budget deficit.) However, if Ukraine were indeed to opt for bilateral or private placement-type financing instead of securing a new IMF program, market participants would very likely be skeptical, partly because of the lack of a solid foundation for tighter policies and reform. Furthermore, **no bilateral loan would be able to match the $12-18 bn IMF financing that may become available** under a new program. – Source: Credit Suisse Economics Research. – *http://www.credit-suisse.com/researchandanalytics.*

- Strengthening of the «investment famine» and decreasing the conditions for sustainable macroeconomic growth,
- Significant decrease/collapse of confidence in the national currency, devaluation expectations as the result of predicted net capital outflows.

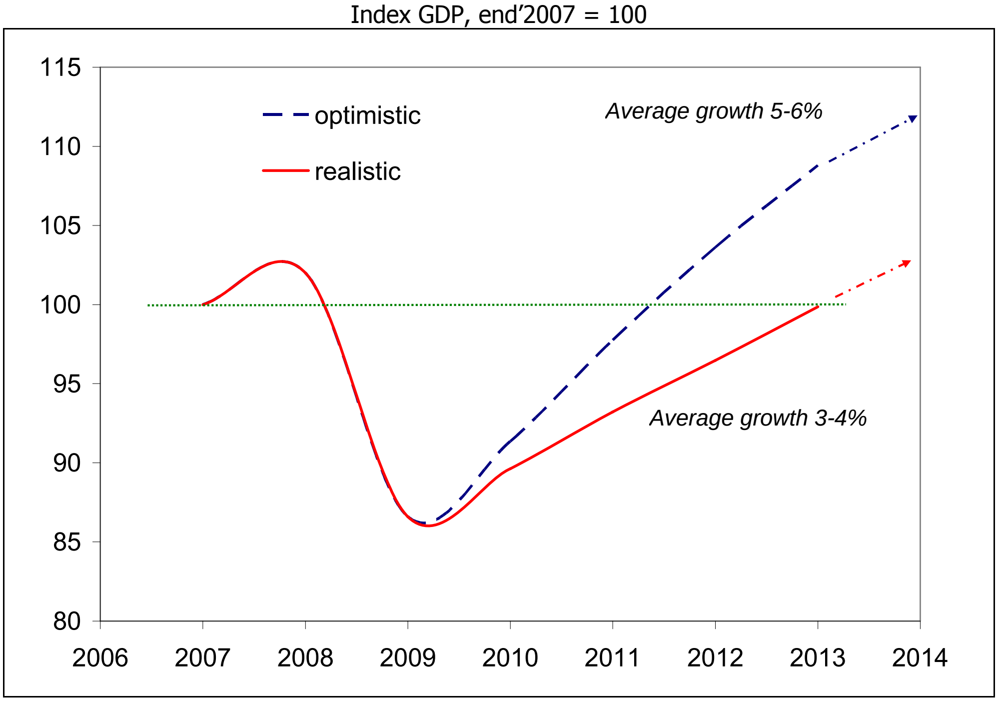
The information on the **refusal to grant credit to Ukraine** or on terminating the cooperation with Ukraine by the IMF **can create a negative informational intervention**. It will consequently create negative secondary effects, which are themselves able to provoke a deterioration of economic conditions:

- Phasing out funding of by other international financial institutions (e.g. World Bank, EBRD);
- Reducing the sovereign ratings of Ukraine and the rising cost of foreign borrowing;
- Complications in restructuring sovereign and corporate debts;
- Outflow of short-term capital;
- Reorientation of population to purchasing (foreign) currencies as the result of the growth of devaluation expectations.

In fact the cooperation between Ukraine and the IMF, followed by the confident implementation of reforms, or delay to them defines two main scenarios of the medium- and long-term development of Ukraine (Diagram "*Optimistic and realistic scenarios of the development of Ukraine*"). As Ukraine is a small, open economy, foreign capital flows are extremely sensitive toward changes in investors' sentiments, precipitating a highly deteriorating effect on the economy. Besides, the Ukrainian banking system remains very vulnerable to solvency risks that restrict resources for growth and development[17]. Thus, fruitfulness of the Ukraine-IMF relationship is crucial for the implementation of these scenarios[18].

Optimistic and realistic scenarios of the development of Ukraine

Index GDP, end'2007 = 100



Source: Derzhcomstst. Forecast: author.

[17] See also: E.Segura, O.Ustenko, etc. Ukraine: Currency and Economic Outlook 2009. – SigmaBleyzer, Febr. 2009.

[18] Here we do not consider the more pessimistic scenario, where Ukraine faces a combination of the deep global slowdown (due to expanding crisis in euro-zone) and imbalanced domestic macroeconomic policies. In such case demand for Ukrainian exports of goods declines sharply, capital outflow speeds up, budget runs in sizable deficit, and weaker currency and sharp reduction in household incomes push the economy into new wave of deep recession.

The **optimistic scenario** is associated with the establishment and consistent implementation of system transformations that during 5-7 years should radically improve the economic and investment environment of Ukraine and bring it into the path of sustainable long-term development. Unfortunately, the experience from previous years indicates a low likelihood of this scenario. Therefore, a second scenario seems to be more realistic. The **realistic scenario** is characterised by slow and cautious improvements, which are not too risky for the government, that mainly support the current structure of the economy, but do not provide significant incentives for improving productivity and incomes of the population. Macroeconomic outlook and forecast for both scenarios is presented in table "*Realistic and optimistic scenarios for Ukraine*").

Realistic and optimistic scenarios for Ukraine

	2008	2009	Realistic			Optimistic		
			2010	*2011*	*2012*	*2010*	*2011*	*2012*
GDP,%	2.1	-15.1	3.5	4.0	3.5	5.0	6.0	5.5
Nominal GDP, UAH bn	950.5	914.7	1046	1220	1400	1070	1300	1550
Nominal GDP, $ bn	181.0	113.9	129.1	151.6	175.0	133.9	164.6	198.7
GDP per capita, $	3927	2482	2826	3331	3863	2930	3617	4387
CPI, % yoy, eop	22.3	12.3	12.0	10.8	9.8	12.0	10.8	9.8
UAH/$, average	5.25	8.03	8.10	8.05	8.0	7.99	7.9	7.8
Budget balance, UAH bn	-25.8	-68.1	-69.0	-65.0	-63.0	-58.0	-52.0	-51.0
Budget balance, % GDP	-2.7	-7.4	-6.6	-5.3	-4.5	-5.4	-4.1	-3.3
CAB, $ bn	-12.8	-1.8	-1.5	-1.0	-1.0	-1.0	-1.7	-1.5
CAB, % GDP	-7.1	-1.6	-1.1	-0.7	-0.6	-0.7	-1.0	-0.8
FDI, $ bn	9.9	4.7	4.2	5.0	4.8	5.5	7.5	6.5
CAB+FDI, $ m	-2.9	2.9	2.7	4.0	3.8	4.5	5.8	5.0
FX Reserves, $ bn, eop	31.5	26.5	24.0	22.0	22.0	25.0	28.0	32.0
Population, ml	46.1	45.9	45.7	45.5	45.3	45.7	45.5	45.3

Realistic scenario. This scenario is the most likely one, with 3-4% growth of GDP in coming years. Our realistic scenario assumes that the global economy remains weak, but the process of recovery continues to strengthen in 2010-2012. This means that the external demand for the Ukrainian products (metal, chemical industries) remains weak and unpredictable. At the same time weak domestic demand and relatively stable world crude oil prices (we assume that in mid-term the price for oil will balance at around current level) and 30% discount for imported gas, helps to curb imports of goods, which remarkable narrow current account deficit (actually balancing current account of the BoP) (see also *"Appendix 1 – Energy pricing"*).

Ukraine exhibits high deficit of public finance in the short-term. According to some estimates, Ukraine's total hidden consolidated deficit in 2010 is projected to exceed 10% of GDP. This figure includes 5.3% primary revenue deficit, around 3% for [gas monopoly] *Naftogaz*, if there is no increase in utility tariffs, 1.5% for the Pension Fund deficit and more than 2% for bank recapitalization[19].

In such conditions depreciation pressure will not be weak but NBU will continue to support hryvnia which depreciate in H2'2010 (from the current 7.92 UAH per $1 to 8.2-8.3 UAH per $1 to the end of the year). However, tight international liquidity conditions and global risk aversion imply that the inflows of foreign capital (both as FDI and loans) remain modest. In particular, FDI inflows are projected at $4-5 bn yearly. It means that investment attractiveness of Ukraine remains depressed and productivity, efficiency and effectiveness of the economy are frozen at an insufficient level.

[19] Source: IMF may not restart lending unless politicians tame deficit. – Kyiv Post, May 2010.

Meanwhile external debt repayments, including sovereign debt, seem quite manageable for 2010-2012[20] (table "*External debt redemption*"). In particular, in 2010, there is only one sizeable FX debt payment (of about $400mn, on a yen-denominated Eurobond) that falls due at the end of the year. Total FX debt payments start to rise in 2012 and peak in 2013 (at $7.9bn, of which $2.6bn will be due to the IMF)[21].

External debt redemption

$ m

	2010	2011	2012
Eurobond market*, total	1765	3011	3258
… including			
Sovereign	642	816	680
Quasi-sovereign	245	973	718
Syndicated loan market	1755	2228	2267

** include interests and principals*

Source: Investment Capital Ukraine LLC, March 2010

Optimistic scenario. According to this scenario the global economy enters a soft but relatively stable recovery path and euro-zone economy restricts its imbalances. As for Ukraine, the key precondition for this scenario is that stabilization packages of the Ukraine's government will be implemented, first of all in the budget sphere (see box "*Tax reform are expected in Ukraine*").

Tax reform are expected in Ukraine

Ukraine's authorities are planning to finish off and approve the Tax Code in 2010. This is provided for the Economic Reform Program for 2010-2014.

The implementation of tax reform will take place in three stages. Authorities are planning at the first place (until the end of 2010) the tax accounting and general accounting are to be brought together, to reimburse the debts for the value added tax (VAT) by the state funds and, beginning from August 1, to reimburse the VAT in time.

The reduction of inefficient taxes and fees (including a simplified taxation system for small businesses), introduction of a single social contribution are planned to realize at the second stage (until late 2012). And also a tax on property, reforming the tax administration, first of all, VAT, and introduction of a mechanism of environmental taxation are also planned to realize.

The third stage of reforming the tax system (until late 2014) requires a phased reduction of tax on profit and the transition to a system of payments for mineral extraction with the application of rental income.

Among the necessary steps in the process of reforming the tax system are gradual increase of the rate of unified social contribution for wage earners.

Source: Tax reform in Ukraine: three stages. – http://mignews.com.ua/en/articles/27679.html.

In this scenario, foreign exchange requirements will be balanced (due to the IMF and World Bank financing) and the exchange rate will even appreciate. Moreover, the continuation of the IMF program will help to maintain investors' confidence at a comfortable level, which facilitates the refinancing of maturing external liabilities of the private sector. The current account can even worsen still remaining in rather small deficit, that reflect expansion of domestic demand and modest improvement in economic environment[22], with additional benefits from cheaper energy

[20] For more details: Investment Capital Ukraine LLC, March 2010

[21] Source: EMEA: A (relative) paragon of fiscal stabilization. – Credit Suisse, February 2010.

[22] Ukraine even can benefit from euro depreciation as far as technological imports from EU becomes cheaper.

imports[23]. Thus in mid-term the current account deficit stabilises at around $1-5-2bn or about 1.0% of GDP in 2011-2012. FDI inflow, particularly due to expansion of privatization processes that peak in 2011, will stimulate appropriate economic growth (see Diagram "*External resources and economic growth*" above) and support the private sector to rollover the maturing external debts (table "*External debt redemption*" above).

5. Conclusions

The difference between scenarios – as reasonable to achieve – presents really big window of opportunities. At the same time, restructuring the management system, eradicating corruption, increasing responsibility and new governance require significantly more time. It is important to note that the realization of the optimistic scenario is much more complicated, since a variety of macroeconomic tasks to be resolved in the post-crisis period will be added to problems of the structural and institutional transformations, which are principally new for Ukraine. Thus, in order to jumpstart the economic recovery in conditions of the problems of post-crisis stabilization, Ukraine should develop those sectors that are characterized by a significant growing potential, as well as the effective use of labour resources. Even if some "traditional" sectors (i.e. metallurgical or chemical industries) remain an important component of the economy, they will not continue to be a moving force for the development of the whole economy, unless the companies change their production or recycling processes for those with a high level of added value. This is, however, rather complicated, since such a demand should be created by a high volume of large domestic customers. Partially, this can be achieved by activation of the projects oriented for the football championship Euro-2012.

The situation in industries, in fact, largely depends on the success of the implementation of the Euro-2012 program. If Ukraine can establish a positive collaboration and give economic guarantees to investors, significant improvements in infrastructure can be expected. Especially, this concerns the construction sector, including the construction of roads. Even in the metallurgical sector, the external demand can be partially substituted by the domestic consumption. Otherwise, if the Euro-2012 program does not work properly, Ukraine will remain hostage to the external conjuncture. There will be no demand for country's export-oriented products and services, so it is unlikely to expect any rapid recovery.

At the same time, there is a high potential in those sectors of the economy, which might be achieved either by the positive economic dynamics of the whole economy, or by their geographical position of the country (Ukraine). In the medium and long term, these sectors are logistics, tourism, construction, and the automobile industries (including their services). The most significant potential is in logistics, wherein coherent development requires the harmonization of customs procedures with neighbouring countries, a significant increase in the quality of roads, transport services and infrastructure, etc.

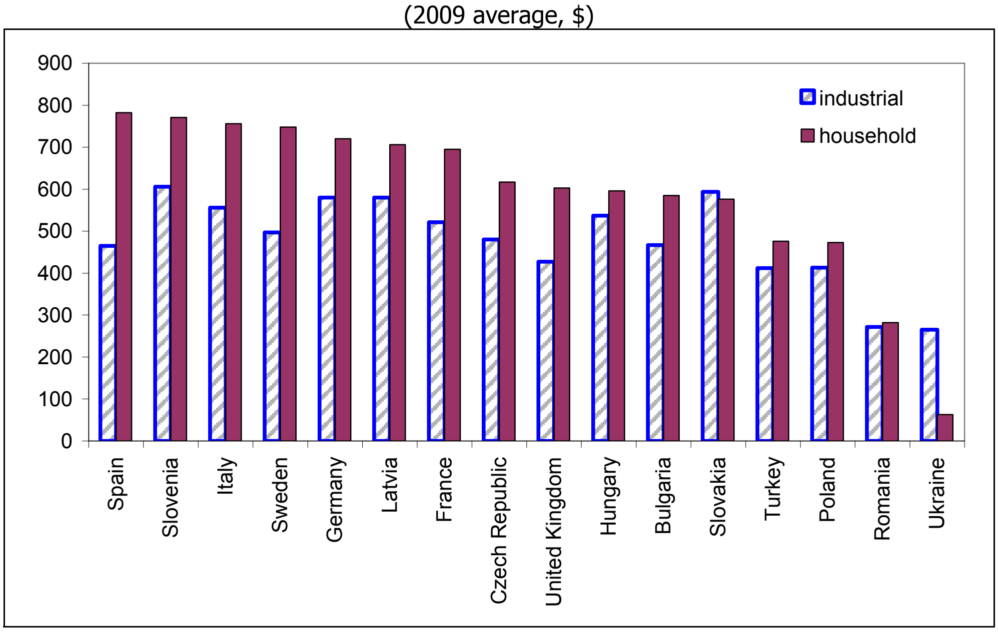
At least, good governance is especially important for Ukraine, since in the conditions of on-going decline of living standards, public trust in the state is almost entirely lost (see also "*Appendix 2 – People expectations*"). **The restoration of that trust – being a prerequisite of the end of the crisis – will depend on sustainable growth of the population income, abidance by the principle of social fairness by the state, and protection of human rights and interests.**

[23] In April 2010 Ukraine and Russia agreed on a 30% discount on the price of imported gas to Ukraine. Thus, the average price for imported gas is now estimated at about $230-245 per 1000m^3 in 2010 compared to the previous $335 per 1000 m^3. Lower gas prices will particularly benefit the natural gas-intensive chemical industry and metallurgy, thus giving stronger impetus to the recovery of the Ukrainian economy. See, for example: O.Pogarska, E.Segura. Ukraine. Macroeconomic Situation. – SigmaBleyzer, April 2010.

Appendices

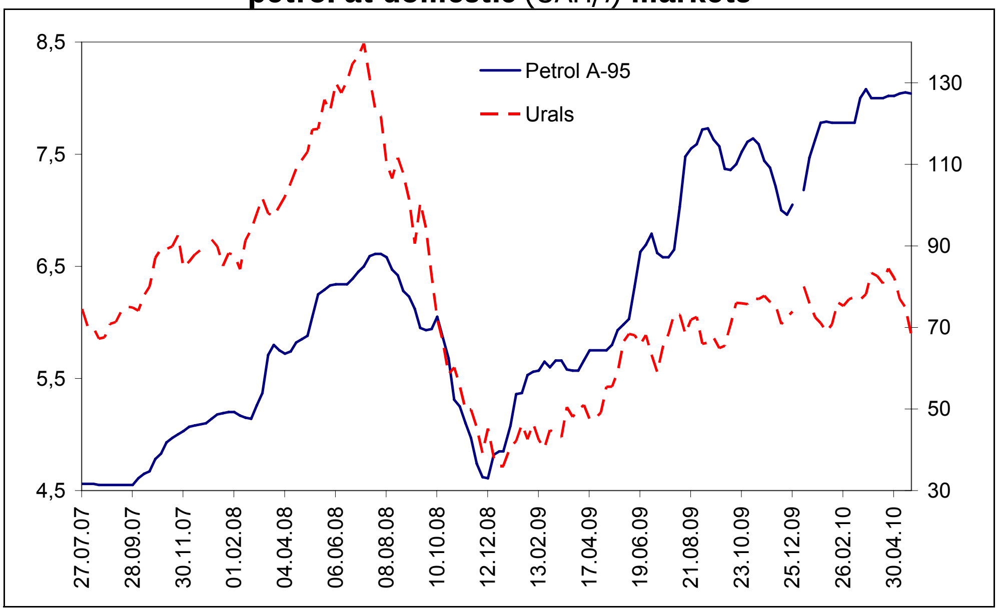
Appendix 1 – Energy pricing. For sure, in deregulation processes should be involved state monopolies, particularly gas sector. Despite its visible "benefits", i.e. low gas prices for households, it is too expensive for the economy in general (for example, due to ever growing deficits in public finances) (Diagram "*End-consumer gas prices…*"). At the same time, oil markets are quite competitive, and prices for petrol in domestic markets are even lower than the prices in neighbouring countries (Diagram "*Prices of oil at international and petrol at domestic markets*").

End-consumer gas prices in Europe and Ukraine
(2009 average, $)



Source: Kyiv Post, 2010, May 7, p.9 (Eurostat)

Prices of oil at international ($/bbl, right scale) **and petrol at domestic** (UAH/*l*) **markets**



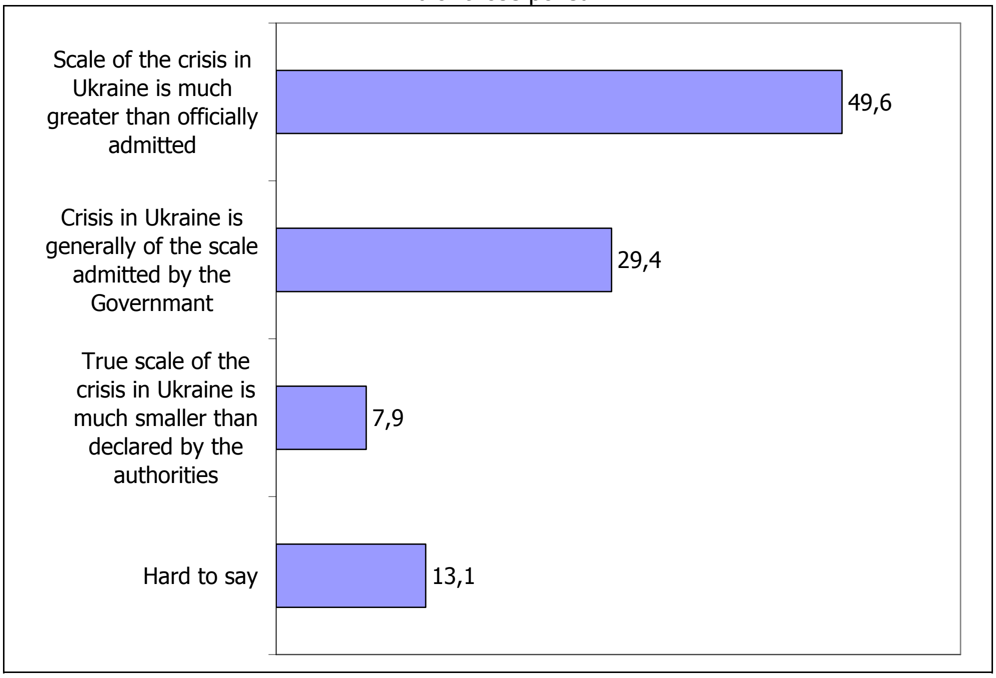
Source: Derzhcomstst.

Appendix 2 – People expectations. The effectiveness of the state policies is impossible to estimate without the analysis of the citizens' situation, understanding and expectations and their ideas for the ways of reversal of negative developments. Thus people's assessments of the economic situation were in the focus of the survey performed by the Razumkov Centre Sociological Service in April, 2010[24]. Several observations would be reasonable to mention.

Assessment of the economic situation. Ukrainian citizens assess the situation in the economy worse than in other sectors: the economic situation and wages – 1.9 points on a fivepoint scale. The state of the social security and pension systems is also described as poor – 2.2 points. Such assessments correlate with the opinion that the scale of the economic crisis is much greater than admitted by the authorities, shared by more than half of citizens (Diagram: "*How would you assess the scale of the economic crisis in Ukraine*?"). 72.8% of citizens believe that exactly the crisis brought about unemployment growth in Ukraine.

How would you assess the scale of the economic crisis in Ukraine

% of those polled



Source: Razumkov Centre

Expectations of changes in the situation. Rather pessimistic assessments of the current situation noticeably contrast with unusual high social expectations for the nearest future – apparently, in connection with the change of the Power (new elected President and government). After new President V.Yanukovych came to power, a relative majority (44.5%) of citizens reports their hope for improvement of the economic situation in the country before the end of 2010; 38.1% hopes for higher wellbeing of their families; 36.1% – for higher wages; and 35.3% – for social security (Table "*How will the situation in Ukraine change in the following sectors…?*").

How will the situation in Ukraine change in the following sectors before the end of 2010? % of those polled

	Will change for better	Will change for worse	Will not change	Hard to say
Economic situation in Ukraine	44.5	9.6	29.1	16.8
Respondent's family level of wellbeing	38.1	9.3	36.4	16.2
Wages	36.1	14.8	31.8	17.3
Situation in a country as a whole	38.2	12.0	32.4	17.4
Confidence of citizens in the future	34.0	12.8	34.9	18.3

Source: Razumkov Centre

[24] The poll was held on April 14-21, 2010. 2009 respondents aged above 18 years were polled in all regions of Ukraine, using a sample representative of the adult population by the key socio-demographic indicators. The poll sample was built as stratified, multistage, random, with respondent quotas at the last stage. The sample theoretical error (without the design effect) does not exceed 2.3% with the probability of 0.95.

Employment policy. Ukrainians aspire to wide-ranging changes in wage and employment policies. Actually the efficiency of the implementation of these policies will depend on the confidence and trust of the people. What can we observe now?

Ukrainians describe as "very effective" and "rather effective" the method of fighting unemployment by wages reform, which will substantially raise the general level of wages, with simultaneous easing of the tax pressure on the enterprise wage funds and toughening enterprise owners' responsibility for timely and full payment of wages to employees (43% and 35%, see *Table "How effective would the following measures be…?"*). They mean therefore a substantial rise of wages as a means of fighting unemployment – since the **unemployed often reject employment proposals exactly because of the low wages offered**.

How effective would the following measures be to fight unemployment in Ukraine?

% of those polled

	Very effective	Rather effective	Ineffective / almost ineffective	Hard to say
Wage reform in the direction of its substantial rise (in times) with simultaneous easing of the tax pressure on the enterprise wage funds and toughening enterprise owners' responsibility for timely and full payment of wages to employees	43.0	35.1	4.5	17.4
Implementation of a large-scale national programme of public works for modern infrastructure creation in Ukraine within two or three years – from local roads to telecommunication networks; restoration of social infrastructure of rural areas; mass construction of social housing	37.0	37.7	6.3	19.0
Reorientation of state policy (budget, investment, tax, etc.) from predominant support for big capital (business) to promotion of small and medium business	30.2	40.2	7.4	22.2

Source: Razumkov Centre